UNIVERSITY OF TORONTO
FACULTY OF LAW

ADVANCED CORPORATE LAW & SECURITIES REGULATION

LAW229H1F
FALL TERM 2008

ANITA ANAND
ASSOCIATE PROFESSOR and
ASSOCIATE DEAN (JD PROGRAM)
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LAW229H1F (Thursdays, 10:30 – 12:20)
FALL TERM 2008

Professor Anita Anand
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Pre-requisites: Business Organizations and Securities Regulation

Course Description

This course explores in greater depth topics explored in Business Organizations and Securities Regulation. Discussion and analysis will centre on contemporary issues in the regulatory regime, such as: corporate governance, securities offerings, acquisition transactions, enforcement issues and the role of the securities regulator. The focus of the course is on statutory and case materials combined with an analysis of relevant academic writings and other secondary materials. In general, the course seeks to integrate a sound understanding of securities regulation and corporate law doctrine with a critical understanding of the policy issues involved. To that end, the course will probe the various interests of relevant stakeholders as they pertain to the issues under discussion and the extent to which the law should protect these interests.

Materials

There will be limited readings assigned for each class. The readings are contained in a cerlox bound volume and are also posted on the Blackboard website.

Evaluation

Students will write a paper of approximately 20-25 pages (worth 80% of the mark) on a topic of their choice (to be approved by the instructor). The other 20% of the student's mark will be based on class contributions, including: participation in class discussion, postings to the Blackboard website, and an on-call day. Students may fulfill the requirements for the SUYRP in this course. The SUYRP must be a minimum of 30 pages (excluding bibliography). Please see the 2008-2009 Syllabus and Academic Handbook for more information.

Preparation for Class

In order to get the most out of the class discussion, you will need to prepare before coming to class. This will mean that you will need to complete the assigned readings and think about points that you would like to raise during the class itself. In addition, posting questions and comments to Blackboard is an effective means of disseminating these points prior to class and allows us all time to think about your substantive comments.

Questions and Meetings

Over the course of the term, you may wish to ask me questions or to speak with me about the course material. I am always willing to respond to these types of queries. Please feel free to raise your questions before or after class, via email or in person. My office hours will be posted on my door. Please sign up on my door if you wish to meet with me. If my door is open and I am in my office, please feel free to drop in and speak to me about your question.

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It's Time, Report of the Wise Persons' Committee to Review the Structure of Securities Regulation in Canada (2003). 198

Jeffrey MacIntosh, "Who Needs a Monopoly?" *The Financial Post* (July 25, 2007). 219

Anita Anand, "Passport to Chaos" *The Financial Post* (July 25, 2007). 221

October 16: Private Equity

○ **Guest: Nathalie Mercure**

(Materials will be distributed)

October 23: Open (Students will have an opportunity to meet individually with Prof. Anand to discuss paper topics and research)

October 30: Cross-border Securities Regulation – Is the US a Model for Canada: Class Actions Case study

What is the landscape and future of securities class actions in Canada? Examining the new liability regime for misrepresentations in continuous disclosure documents

○ **Guest: Professor Adam Pritchard, Faculty of Law, University of Michigan**

Adam Pritchard, Janis Sarra, "The Future of Securities Class Actions in Canada" (2008 Draft). 224

November 13: Corporate governance and Cross-border implications

Independent Boards: What's the big deal?

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November 20: Securities Regulators, Administrative Tribunals and Bifurcation

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○ **Guest: Lorne Sossin, Faculty of Law, University of Toronto**

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Philip Anisman, "The Ontario Securities Commission As Regulator: Adjudication, Fairness and Accountability" in *Conflicts of Interest in Capital Market Structures.* Eds. Anita I. Anand and William F. Flanagan. Queen's Annual Business Law Symposium (Kingston: Carswell, 2003) 101. 324

November 27: Enforcement Powers and quasi-criminal litigation

Are Canadian governments (provincial and federal) and securities regulators effectively monitoring and enforcing financial crimes?

○ **Guest: Michael Code, faculty of Law, University of Toronto**

Anita Anand, "Carving the Public Interest Jurisdiction in Securities Regulation: Contributions of Justice Iacobucci" (2007) 57 U.T.L.J. 293. 349

Mary Condon, "Rethinking Enforcement and Litigation in Ontario Securities Regulation" (2006) 32 Queen's L.J. 1. 360

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Excerpt from

Securities Law in Canada: Cases and Commentaries

Mary Condon, Anita Anand, Janis Sarra

Introduction

Issues pertaining to securities law have been front-page news over the last few years, as a result of stock market volatility, financial scandals, and a renewed public interest in the internal activities of large business organizations and the entities that regulate them. The adequacy or otherwise of securities regulation of market actors has been intensely debated by market participants, regulators, investors, and the public. One result has been a flurry of new regulatory law pertaining to securities markets in Canada. We attempt in this casebook to present, and reflect on, this plethora of new legislative and regulatory developments, recognizing that in all likelihood the pace of legislative and regulatory change will continue to make an up-to-date statement of securities law in Canada an elusive goal. It should be immediately noted that the very term "Canadian securities law" is not a recognized legal category. The law relating to securities markets in Canada is provincial, though the federal government has been canvassing possibilities to enter the field. These initiatives are discussed in chapters 1 and 2. We do not aim to provide a complete description of securities regulation in all Canadian provinces and territories, but it is an important goal of this casebook to convey a flavour of both the attempts to harmonize substantive provisions of provincial securities regulation across the country and the important differences that remain. It should also be acknowledged that international developments and economic globalization are a growing influence on the nature and pace of change in Canadian regulation. This issue is addressed in chapter 2.

In this introduction, we hope to accomplish three things. The first is to provide students coming to securities law for the first time with a brief overview of the scope of the subject and the topics to be canvassed in the chapters that follow. The second is to identify a number of possible intellectual frameworks that could or have been used to explain, critique, or suggest reform to the current iteration of securities law rules in various provinces. The third is to help students navigate the initially confusing layers of "law" in this area by describing the various sources of relevant regulatory pronouncements.

I. WHAT IS SECURITIES REGULATION ABOUT?

As we will see when cataloguing the sources of securities law, securities regulation is largely statutory law, or law derived from various forms of delegated legislation. In that sense, it requires greater attention to issues of statutory interpretation than many other "common law" subjects. Substantively, securities law is the law relating to the issuing of various types of financial instruments or claims, known as securities, by business or

financial organizations to purchasers, with a view to raising capital for enterprises. The classic example of a security is a company share, but other, more esoteric examples include units of income trusts or so-called viatical settlements. Both of these forms of security are described in chapter 3. One of the roles of securities law is to govern the capital-raising process. The basic assumption is that an efficient capital-raising process for business enterprises is central to a healthy economy. To achieve this objective, it is thought necessary for prospective investors to have well-founded confidence in the ability of securities markets to act as intermediary between investors and business enterprises. A set of legal rules is supposed to enhance that confidence. In general terms, then, securities regulation is the ongoing attempt to draw a balance between an efficient capital-raising process and the operation of efficient securities markets, and an acceptable comfort level for investors that business enterprises of one kind or another are a good place to invest their savings. The objectives of Ontario securities law, for example, are expressed in s. 1.1 of the Ontario *Securities Act* (OSA) (RSO 1990, c. S.5, as amended) as being "(a) to provide protection to investors from unfair, improper or fraudulent practices; and (b) to foster fair and efficient capital markets and confidence in capital markets." Of course, not all of those subject to regulation believe that the government or the regulators get this balance right. We will see many examples of contestation about this issue in the pages to follow. Some current examples are debates over civil liability provisions for misrepresentation in continuous disclosure documents and complaints about the onerous nature of prospectus disclosure requirements. It is clear, however, that the ideas of fairness and confidence expressed in the goals of securities law contain significant ambiguity and require regulators to exercise judgment in a variety of situations.

How does securities law assist in regulating economic activity? Having defined what a security is, it establishes the legal requirements to be fulfilled by issuers of securities in order to validly sell the securities to purchasers. Even more important from a practitioner's point of view, it creates exceptions to those rules. Securities law also clarifies the ongoing responsibilities of issuers to purchasers and repurchasers of their securities in the secondary trading markets (where already-issued securities trade). This body of law also deals with legal requirements imposed on those in a special position in the issuer (including those in effective control of it) who wish to sell their securities. It establishes other requirements for more general changes in control of the issuer by way of the sale of issuer securities. Importantly, securities law also provides both civil and criminal remedies for breaches of the substantive requirements of the law, the most notorious of which is the prohibition against insider trading. A further significant component of securities law, but one that often remains undiscussed in basic law school courses, is the regulation of intermediaries in the markets, such as brokers, advisers, and mutual fund sales personnel. It is assumed that investors, while they may benefit from the expertise provided by these intermediaries, also need to be protected from the risk that these professionals will be tempted by the possibilities for advancing their own personal interests at the expense of their clients. In sum, securities law is often described as being composed of three main strategies of regulation; (1) disclosure of information, (2) registration requirements, and (3) after-the-fact enforcement by regulators or investors themselves. (See OSA s. 2.1 and David Johnston and Kathleen Doyle Rockwell, *Canadian Securities Regulation*, 3d ed. (Toronto: Butterworths, 2003).) The chapters to follow canvass all of these issues in detail.

In the preceding description of the main contours of many provincial securities acts in Canada, it is worth noting that securities law governs only some aspects of the relationship between a business organization and its investors. Provincial and federal corporate law also deals with this relationship, as does commercial law. Indeed, one ongoing theme in academic commentary on securities law is the plausibility or otherwise of a clear dividing line between what constitutes corporate law and what is securities law. This issue is addressed in chapter 7. (See Anita Anand, "OSC's Power Warrants Close Scrutiny," *Financial Post*, June 27, 2003, FP11.) Of course, business enterprises that do not issue securities to the "public" may not have to worry about the dictates of securities law, but many enterprises are subject to both sets of enactments. Furthermore, business organizations have legal relationships and responsibilities to constituencies other than their investors, such as their employees, consumers, and creditors. These relationships are outside the purview of securities law per se. We will see, however, that, in accordance with the expressed goals of securities legislation, securities regulators focus a great deal of regulatory effort on maintaining confidence in securities markets generally, as well as legal relations between individual issuers and their investors. This task is becoming ever more significant as the financial markets become an increasingly vital source of wealth in the economy generally, and may explain why the deployment of regulatory resources in the area of securities law has remained robust, even as regulatory resources have been withdrawn from other important public policy concerns, such as the regulation of the labour market or the environment. The role played by financial markets is evidenced both by the numbers of people who work in the financial services sector and, more significantly, as described in chapter 2, by the increasing numbers of Canadians who depend for their retirement financial well-being on returns from investments in securities markets. (See also Mary Condon, "Privatizing Pension Risk: Gender, Law and Financial Markets," in B. Cossman and J. Fudge, eds., *Privatization, Law, and the Challenge to Feminism* (Toronto: University of Toronto Press, 2002), 128-65.)

Reference to the role played by the financial markets in securing the financial well-being of "ordinary Canadians" should not obscure the fact that there is more than one kind of investor in securities markets. The scholarship in this area, and in some instances, securities legislation as well, often makes a distinction between the needs of so-called retail investors and those of so-called institutional investors. The latter category includes various types of financial organizations such as banks, insurance companies, mutual funds, and pension funds, for whom investment in securities markets is a professional activity. The supposed tension between the respective regulatory needs of these constituencies is reflected in a variety of ways in substantive securities regulation. Examples include the exemption of issuers from information disclosure requirements when dealing with so-called accredited investors (see chapter 5) and the existence of exemptions from the takeover bid regulatory regime for "private agreement" or "control block" takeovers (see chapter 9). (See also Donald C. Langevoort, "Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrockers and Sophisticated Customers" (1996) no. 84 *California Law Review* 627.)

II. INTELLECTUAL PERSPECTIVES ON SECURITIES LAW

Like any other body of law, securities law can be analyzed in either normative or descriptive terms. Normatively, the analyst can assess the values or goals that are or should be achieved by various aspects of the law under consideration. Descriptively, the analyst can examine the operation of the body of law with a view to understanding why it operates the way it does, or why it came into being as it has. There is obviously scope for overlap between these two approaches to analyzing law, with some approaches, for example, a neoclassical economic approach, purporting to be both normative and descriptive. We consider it useful at the outset to canvass some salient frameworks for analysis that could be used to evaluate specific aspects of the substance of securities law. We start with the most widely employed intellectual perspective on securities law.

A. Neoclassical Economic Analysis

The underlying premise of this approach is that individuals should be free as far as possible to make their own choices, because individuals are capable of acting rationally so as to maximize their own welfare. Overall welfare is maximized when the bargains that individuals enter into make them better off, and no one is thereby made worse off. As the excerpt below explains, this notion of Pareto efficiency is enhanced by the Kaldor-Hicks version of efficiency, which is said to result when the winners, in any particular bargaining situation, could compensate the losers and still come out ahead. Further, markets are typically the best organizing device for facilitating the making of individual bargains. Thus, legal rules or government intervention should replace or frame private bargaining in markets only in limited situations. One situation would be the case of "market failure." In the securities law context, market failure would occur when efficient transactions do not result because the market fails to voluntarily provide sufficient information on which to base an investment decision. Disclosure rules in securities law are often analyzed and/or critiqued in these terms. Another legitimate role for securities laws might be that of "gap filling." This is the idea that securities regulation can supply the terms of individual bargains that contractors would have required had they addressed their minds to these issues. A related economic rationale for having a legal rule in any particular instance is that the effect of having the rule lowers the transaction costs that would otherwise be incurred in the making of individual bargains. The excerpt below explains some of these issues at greater length. As you read it, consider how it might apply to securities regulation specifically.

Michael J. Trebilcock, *The Limits of Freedom of Contract*
(Cambridge, MA: Harvard University Press, 1993), chapter 1 (footnotes omitted)

The central preoccupation of economics is the question of choice under conditions of scarcity. Given scarcity, economics assumes that individuals and communities will (or should) attempt to maximize their desired ends (which may be of infinite variety) by doing the best they can with the limited resources (means) at their disposal. To the extent that means (or resources) can be made relatively less scarce, or stretched further, more ends or goals of individuals or communities can be realized. Obviously the legal system, in important ways, structures the choices available to individuals and groups in a broad range of settings. In analyzing issues of choice under conditions of scarcity and subject to other constraints, including those imposed by the legal system, neo-classical economics employs two conceptually different kinds of analysis. The first is conventionally referred to as positive analysis, meaning descriptive or predictive analysis. The second is normative analysis, meaning prescriptive or judgmental analysis. The first kind of analysis tends to be much less controversial than the second.

Positive Economics

An analyst adopting a positive economic perspective tends to ask the following kind of question: If this (legal) policy is adopted, what predictions can we make as to the probable economic impacts, allocative (the pattern of economic activities) and distributive (winners and losers), of the policy, given the ways in which people are likely to respond to the particular incentives or disincentives created by the policy? In predicting these behavioural responses, the positive analyst will assume that most individuals are motivated by rational self-interest, in the sense of maximizing their individual utilities, subject to whatever constraints are imposed on the choices open to them. Utility functions may be infinitely varied. Mother Teresa may be motivated out of pure altruism to buy rice on the best possible terms from rice dealers to feed starving children in the streets of Calcutta. Another person may be motivated out of a desire to sustain a decadent lifestyle to buy narcotics for dealing to drug addicts, causing enormous human suffering as a result. In conventional supply and demand analysis, it is assumed that in most contexts more goods or services will be supplied at higher than lower prices and that fewer goods or services will be demanded at higher prices than lower prices—supply curves slope up to the right, demand curves slope down to the right. Even the supply of altruism is likely to be inversely related to its cost; for example, more blood (a renewable resource) is likely to be supplied altruistically than are steak and potatoes. Thus, positive economic analysis is individualistic and subjective in its behavioural premises. A positive analyst of legal issues back in the 1920s might have asked, what behavioural responses on both the supply and demand sides can be predicted in reaction to Prohibition laws? Similar questions might be asked today about various features of the war on drugs. Or the analyst might ask, what kind of first- and second-order behavioural responses might one predict to rent control laws, or agricultural supply management regimes that impose price floors and production quotas on producers, or minimum wage laws, or cost-plus regulation of public utilities, or exclusive dealing contracts, or the adoption of strict products liability over negligence? and so on. Understanding the incentives effects of these various regimes is a necessary prelude to formulating normative judgments as to the merits of the regime under analysis relative to different policies that might be employed to pursue the same or alternative social goals.

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Normative Economics

The orientation of normative economic analysis, like positive analysis, is individualistic and subjective. This style of analysis—conventionally referred to as welfare economics—would tend to ask the question, is it likely that this particular transaction, or this particular proposed policy or legal change, will make individuals affected by it better off in terms of how they perceive their own welfare (not how some external party might judge individuals' welfare)? In this context, two concepts of efficiency are of central importance: Pareto efficiency and Kaldor-Hicks efficiency. Pareto efficiency would ask of any transaction or policy or legal change, will this transaction or change make somebody better off while making no one worse off? Kaldor-Hicks efficiency, in contrast, would ask the question, would this collective decision (for example, a change in legal rules) generate sufficient gains to the beneficiaries of the change that they could, hypothetically, compensate the losers from the change so as to render the latter fully indifferent to it but still have gains left over for themselves? This second approach is effectively a form of cost-benefit analysis. Let me elaborate a little on these two concepts of efficiency.

Neo-classical economists in general attach strong normative value to regimes of private exchange and private ordering and often bring some degree of scepticism to bear on the capacity of collective decision-makers, including legislatures, regulators, bureaucrats, or indeed courts, to adopt policies or laws that will unambiguously increase net social welfare. This predilection for private ordering over collective decision-making is based on a simple (perhaps simple-minded) premise: if two parties are to be observed entering into a voluntary private exchange, the presumption must be that both feel the exchange is likely to make them better off, otherwise they would not have entered into it. Thus, in most exchanges, the economic presumption is that they make all the parties thereto better off, that is, they are Pareto superior. This presumption is rebuttable by reference to a fairly conventional list of forms of market failure or, in a transaction-specific context, contracting failure, which neo-classical economists recognize as inconsistent with this presumption, for example, monopoly, externalities, information failures. Or, as Milton Friedman puts the presumption in *Capitalism and Freedom*: "The possibility of coordination through voluntary co-operation rests on the elementary—yet frequently denied—proposition that both parties to an economic transaction benefit from it, provided the transaction is bilaterally voluntary and informed."

Collective decisions which are not the result of voluntary agreement among all affected parties may technically be able to satisfy the Pareto criterion (making some better off and none worse off), but typically such decisions will generate both winners and losers. The question for the economist then becomes whether the net effect of these decisions is an increase in social welfare as judged by all affected individuals in terms of the impact of such decisions on their levels of present or prospective utility. The central difficulty here is that these impacts on individuals' utility functions are not directly observable by collective decision-makers and there is no ready way of ensuring accurate revelation by individuals of their evaluation of these impacts, thus rendering the utilities and disutilities associated with such a decision largely

unmeasurable and incommensurable. For example, suppose that it were proposed that a major new multi-lane highway be constructed through an urban area, generating gains in utility for commuters from more distant areas but losses in utility to inner-city residents immediately adjacent to the throughway. How can decision-makers be confident that the net effect on social welfare of a decision to proceed with construction of the throughway will be positive? Similar questions arise with respect to changes in legal regimes which are imposed on affected parties by collective decision and which make some individuals better off and others worse off. How does one go about determining whether the gains in utility to one group exceed the losses in utility to the other? Thus, economists feel much more confident making welfare judgements about the impact of private exchanges on the parties thereto than the impact of collective decisions on all parties affected by them.

The Economic Functions of Contract Law

As noted above, neo-classical economists have a predilection for resource allocation through voluntary exchanges as opposed to collective decisions because they believe that one can have a higher degree of confidence in the welfare implications of private exchanges, where both parties stand to benefit, than in collective decisions, where typically there are both winners and losers and it is difficult to net out gains against losses. However, this predilection for the private exchange or market process in the allocation of resources does not speak to the economic role of contract law.

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Reducing Transaction Costs

A second economic function of the law of contracts is to supply parties to given categories of exchanges with standard sets of implied terms, which in most cases save the parties the transaction-costs entailed in fully specifying a complete contingent claims contract, but typically leave them free to contract out of these rules if they find them inappropriate to their particular transaction. In addition to various aspects of the common law of contracts, many statutes dealing with sales law and partnership law, and perhaps certain aspects of corporation statutes, can be thought of in these terms.

Filling Gaps in Incomplete Contracts

A related function of the law of contracts is to provide a set of default or background rules where the explicit terms of a contract are incomplete, not because the parties consciously adverted to the default or background rules and accepted them as appropriate to their transaction, but typically because particular contingencies were not consciously adverted to by one or the other party (or both) at all. Here, an economic framework of analysis would tend to ask, what rule would maximize the parties' joint welfare, on the assumption that this rule would generally be the rule that rational parties would have agreed to ex ante?

Distinguishing Welfare-Enhancing and Welfare-Reducing Exchanges

A central economic role of contract law is to formulate a set of excuses for contract performance that permits the enforcement of efficient exchanges but discourages the enforcement of inefficient exchanges. Individual exchanges might be evaluated from a Paretian perspective, where one would ask whether it is reasonable to infer that such exchanges are welfare-enhancing in the sense of making somebody better off and somebody worse off. Lack of voluntariness, imperfect information, and externalities are likely to provide the principal economic bases for declining to draw such an inference, whatever the legal forms that excuses reflecting these factors might take. Alternatively, one could employ a Kaldor-Hicks criterion of efficiency, asking whether society on net would be better off by permitting the class of transaction of which the instant transaction is representative or if, in contrast, society would be better off on net by imposing certain legal rules or constraints on the class of transaction in question. ... Economists are not always precise about which of these two concepts of efficiency should be employed and when.

Thus, neo-classical economists' predilection for private ordering turns centrally on legal regimes of well-defined and exclusive private property rights and a regime of contract law that facilitates the voluntary exchange of those rights.

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6 Thus, from an economic perspective, one could analyze various securities law rules in terms of whether they work to reduce transaction costs, thereby contributing to the efficiency of securities markets. Similarly, disclosure of information is said to contribute to the informational efficiency of these markets. The question for analysts of securities law is whether mandatory disclosure rules are more efficient than private bargaining about information provision.

B. Behavioural Finance

A more recent innovation in response to the normative approach that elevates rational individual decision making to paramountcy is the behavioural perspective. This approach attempts to import insights from psychology into an empirical exploration of how individuals actually behave in making decisions, and the factors that influence that decision making. The claim that individuals act emotionally or with overconfidence, or that "loss aversion" or complicated forms of "mental accounting" frame their investment decision making, obviously raises the issue of the extent to which the legal rules governing securities trading do or should respond to these empirical claims. The excerpt below canvasses some of the insights of this framework for analysis.

John R. Nofsinger, *The Psychology of Investing*, 2d ed.
(Upper Saddle River, NJ: Pearson Prentice Hall, 2005)

Chapter 1 Psychology and Finance

Behavioral Finance

Even the smartest people are affected by psychological biases, but traditional finance has considered this irrelevant. Traditional finance assumes that people are "rational" and tells us how people should behave in order to maximize their wealth. These ideas have brought us arbitrage theory, portfolio theory, asset pricing theory, and option pricing theory.

Alternatively, behavioral finance studies how people actually behave in a financial setting. Specifically, it is the study of how psychology affects financial decisions, corporations, and the financial markets. This book focuses on a subset of these issues—how psychological biases affect investors. The investor who truly understands these biases also will appreciate more fully the tools traditional finance has provided.

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Chapter 3 Pride and Regret

Disposition Effect

Avoiding regret and seeking pride affects people's behavior, but how does it affect investment decisions? Two financial economists, Hersh Shefrin and Meir Statman, adapted this psychological behavior to the investor. They show that fearing regret and seeking pride causes investors to be predisposed to selling winners too early and riding losers too long. They call this the disposition effect.

Consider the situation in which you wish to invest in a particular stock. However, you have no cash and must sell a position in another stock in order to have the cash for the new purchase. You can sell either of two stocks you hold. Stock A has earned a 20 percent return since you purchased it, whereas stock B has lost 20 percent. Which stock do you sell? Selling stock A validates your good decision to purchase it in the first place. It would make you feel proud to lock in your profit. Selling stock B at a loss means realizing that your decision to purchase it was bad. You would feel the pain of regret. The disposition effect predicts that you will sell the winner, stock A. Selling stock A triggers the feeling of pride and allows you to avoid regret.

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Chapter 4 Considering the Past

> *A person who has not made peace with his losses is likely to accept gambles that would be unacceptable to him otherwise.*
>
> — Kahneman and Tversky

Consider this wager on a coin toss: Heads you win $20, tails you lose $20. Would you take this gamble? By the way, you won $100 earlier. Now would you take this gamble? Did your answer change after finding out that you had won earlier? What if

you had lost $20 earlier? Would this make the gamble look any different to you? Many people will take the gamble in one situation but not in another. The odds of winning the $20 do not change in the different scenarios, so the expected value of the gamble remains the same. Neither the risk nor the reward of the gamble changes between situations; therefore, people's reaction to risk must change.

People seem to use a past outcome as a factor in evaluating a current risky decision. In short, people are willing to take more risk after earning gains and less risk after losses. To illustrate this behavior, Richard Thaler and Eric Johnson asked 95 undergraduate economics students to take a series of two-step gambles using real money. In the first step, money was either given or taken from the student. In the second step, the student was asked whether he or she wished to take the gamble presented. Their findings suggest a "house-money effect," a risk-aversion (or snake-bite) effect, … which are discussed in the following sections.

House-Money Effect

After people have experienced a gain or profit, they are willing to take more risk. Gamblers refer to this feeling as playing with the house's money. After winning a big sum, amateur gamblers don't fully consider the new money as their own. Are you willing to take more risk with your opponent's money or your own money? Because gamblers don't fully integrate their winnings with their own money, they act like they are betting with the casino's money.

Risk-Aversion (or Snake-Bite) Effect

After experiencing a financial loss, people become less willing to take a risk. When faced with a gamble after already losing money, people generally choose to decline the gamble. Students who initially lost $7.50 were then asked to wager $2.25 on the flip of a coin. This time, the majority (60 percent) declined the gamble. After losing the initial money, the students might have felt "snake bit."

Snakes don't often bite people, but when it happens the person becomes more cautious. Likewise, after having been unlucky enough to lose money, people often feel they will continue to be unlucky; therefore, they avoid risk.

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Endowment (or Status Quo Bias) Effects

People often demand much more to sell an object than they would be willing to pay to buy it. This is known as the endowment effect. A closely related behavior is people's tendency to keep what they have been given instead of exchanging it, known as status quo bias.

Economists have examined the endowment effect by running experiments using their students. A common experiment is to give an object such as a university coffee mug to half the students in class. An ensuing market is created so those students with mugs who don't want them can sell them to students who want the mugs and don't have them. Traditional economic theory predicts that a market-clearing price will

develop such that half the mugs will exchange hands. That is, half of the students who were given mugs will sell them to half of the students who did not receive a mug. However, in repeated experiments, students endowed with a mug typically demand twice the price that students without a mug are willing to pay. As a consequence, few mugs actually are traded. This finding occurs in experiments using different objects and using a repeating game, where students get experience trading in this type of market.

What creates this endowment effect? Do people overestimate the value of the objects they own, or does parting with them cause too much pain? Consider the following experiment. Students were asked to rank the attractiveness of six prizes. A less attractive prize, a pen, was given to half the students in the class. The other half of the class had a choice between the pen and two chocolate bars. Only 24 percent of the students picked the pen. The students who were originally given the pen were then given the opportunity to switch to the chocolate bars if they wanted. Even though most students ranked the chocolate higher than the pen as a prize, 56 percent of the students endowed with the pen elected not to switch. It does not appear that people overestimate the appeal of the object they own. Rather, they are more affected by the pain associated with giving up the object.

Endowment and Investors

How can endowment or status quo bias affect investors? People have a tendency to hold the investments they already have. For example, William Samuelson and Richard Zeckhauser told students to imagine that they just inherited a large sum of money. They can invest the money in different portfolios. Their choices are a moderate-risk company, a high-risk company, treasury bills, or municipal bonds.

Many versions of this question were asked. In some versions, the subjects were told that the inheritance was already invested in the high-risk company. In other versions, the inheritance came in the form of the other investment options. Interestingly, the form of the investment at the time of endowment heavily influenced the portfolio choices made by the subjects. The high-risk company choice was more popular when the inheritance was already invested in the high-risk company. The same was true for the treasury bill. Clearly, the expected risk and return of portfolios dominated by treasury bills and high-risk companies are very different, yet subjects were more influenced by the status quo than by their own risk and-return objectives.

The status quo bias increased as the number of investment options increased. That is, the more complicated the decision that was needed became, the more likely the subject was to choose to do nothing. In the real world, investors face the choice of investing in tens of thousands of company stocks, bonds, and mutual funds. All of these choices may overwhelm some investors. As a result, they often choose to avoid making a change. This can be a particular problem when the investments have lost money. Selling a loser would trigger regret (Chapter 3) and the pain of losing the endowment.

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Cognitive Dissonance and Investing

Investors seek to reduce psychological pain by adjusting their beliefs about the success of past investment choices. For example, at one point in time, an investor will make a decision to purchase a mutual fund. Over time, performance information about the fund will either validate or put into question the wisdom of picking that mutual fund. To reduce cognitive dissonance, the investor's brain will filter out or reduce the negative information and fixate on the positive information. Therefore, investor memory of past performance is better than actual past performance. In other words, you view yourself as a good investor, so the memory of your past investment performance adapts to be consistent with the self-image. You remember that you have done well, regardless of the actual performance.

William Goetzmann and Nadav Peles measured the recollections of investors. They asked investors two questions about the return on their mutual fund investments during the previous year: (1) What was the return last year? (2) By how much did you beat the market? Note that these questions ask about actual performance and performance relative to possible alternatives. If investors are not biased by cognitive problems, then the average recollection of performance should be equal to the actual performance.

Also consider the responses of investors in a simulated market experiment. The performance of 10 real mutual funds, a money market fund, and the S&P 500 Index over the 10-year period 1985 to 1994 were used in the simulation. Eighty master's-level business students allocated $100,000 to the investments as they wanted. Then 6-month returns are revealed to the investors, and they may re-allocate their portfolio. This was repeated until 20 turns of the game were completed. Note that throughout the experiment, the players saw the market return (as proxied by the S&P 500 Index) and their own portfolio holdings. After the game, the players were asked how they performed. What return did they get? Did they beat the market? On average, the players reported that they beat the market. This is a rosy perception of their performance because the group's average return was 8 percent below the market. When asked about their return, only 15 of the 80 were correct. A majority (47 out of 80) overestimated their total return.

People want to believe that their investment decisions are good. In the face of evidence to the contrary, the brain's defense mechanisms filter contradictory information and alter the recollection of the decision. It is hard to evaluate the progress toward investment goals or the need for an investment adviser objectively when the recollection of past performance is biased upward.

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Chapter 5 Mental Accounting

Mental Accounting and Investing

Decision makers tend to place each investment into a separate mental account. Each investment is treated separately, and interactions are overlooked. This mental process can adversely affect an investor's wealth in several ways. First, mental accounting exacerbates the disposition effect discussed in Chapter 3. Recall that investors avoid selling stocks with losses because they do not want to experience the emotional pain of regret. Selling the losing stock closes the mental account, triggering regret.

Mental budgeting compounds the aversion to selling losers. Consider how people value the timing of payments and benefits. As time passes, the purchase of the stock becomes a sunk cost. The emotional pain of wasting some of the sunk cost on a loser diminishes over time. It may be less emotionally distressing for the investor to sell the losing stock later as opposed to earlier.

When investors do decide to sell a loser, they have a tendency to bundle more than one sale on the same day. Investors integrate the sale of losers to aggregate the losses and limit the feeling of regret to one time period. In other words, people may combine the separate mental accounts in losing positions and close them out all at once in order to minimize their regret. Alternatively, investors like to separate the sale of winners over several days to prolong the more favorable feeling. Sonya Lim studied the selling behavior of 158,000 brokerage accounts from 1991 to 1996. She found that investors are likely to sell more than one losing stock on the same day. On the other hand, if a winner stock is sold, selling another winner stock on the same day is less likely.

The narrow framing aspect of mental accounting might also explain why most people do not invest in the stock market, even though stocks have a high mean return. The stock market risk has nearly zero correlation with a person's other economic risk, namely, labor income risk and housing price risk. Therefore, adding even a small amount of stock market risk provides diversification of one's overall economic risk. However, in isolation, which is how people tend to view things, the stock market appears much riskier than labor income risk and housing price risk. Last, mental accounting also affects investors' perceptions of portfolio risks. The tendency to overlook the interaction between investments causes investors to misperceive the risk of adding a security to an existing portfolio. … [M]ental accounting leads to the building of portfolios layer by layer. Each layer represents the investment choices that satisfy various mental accounts. This process allows investors to meet the goals of each mental account separately. It does not lead to the benefits of diversification shown by portfolio theory. That is, this process does not necessarily lead to lower risk. Therefore, investors end up not maximizing their return given the level of risk they take.

As we can see, the results of this empirical research suggest a number of questions for analysts of securities law. For example, can or should securities law rules take account of the "disposition effect," whereby people tend to avoid regret by not selling losers? Should the takeover bid rules respond in any way to the claims of behavioural researchers about "endowment effects," which suggest that people demand more to sell something than they would be willing to pay to buy it? How might the evidence that investors engage in "mental accounting" have an impact on the investment advice given by intermediaries to investors?

C. Socio-Legal Approaches

The socio-legal perspective on the operation of securities markets embraces a diverse set of normative and empirical approaches. One very broad generalization might be that analysts operating from a socio-legal perspective are interested in considering markets as embedded in a set of social and cultural relations. They are concerned to explore the ways in which markets both influence and are influenced by those social and cultural relations. Scholarship that investigates the conjuncture of political, economic, and historical factors that influence the terms of legislation and rule making is one example of this approach. Another subset of literature that might fall under this rubric is devoted to examining the influence of powerful interest groups in shaping the substance of legislation or rules. Examples of such groups in the context of securities markets include the Toronto Stock Exchange (TSX), the Investment Dealers Association (IDA) (the group that represents and self-regulates the major investment dealers and brokerage firms operating in the securities markets), major Canadian corporations, and the securities regulators themselves. Assuming that the influence of powerful interests can in fact be descriptively catalogued, whether it is considered to be normatively problematic is a separate issue. Public choice theory in neoclassical economics would argue for the normative appropriateness of this outcome, on the basis of efficiency, whereas a proponent of a critical or social justice perspective would point to the possibility of oppression of some constituencies by others. A related issue here is the extent to which rules that were designed to address specific historical and economic problems when they were introduced, and to meet the needs of a specific constituency such as retail investors, are still appropriate for modern-day markets and modern-day economies.

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Mary G. Condon, *Making Disclosure: Ideas and Interests in Ontario Securities Regulation*

(Toronto: University of Toronto Press, 1998), 4-7 (footnotes omitted)

The second major concern of regulation scholars is that of constructing explanations for the behaviour of regulatory agencies. This task is obviously closely linked to the project of ascertaining and judging regulatory goals. Regulatory behaviour is thought to need explanation because of a perceived pathology with respect to the identified goals. The behavioural explanations available are many and varied. In accordance with the personification implied by the notion of behaviour, several versions of the "life cycle" theory have been mooted. In the United States in the 1950s the view was popular that as agencies grew older, they matured and became less aggressive in their dealings with their regulatory clients. On the other hand, arguments have been propounded that agencies are engaged in a constant effort to broaden the scope of their activities and expand their ambit of authority.

Some accounts focus on the prescience and philosophies of key actors—usually chairs—within agencies, to explain their behaviour. For example, T.K. McCraw examines the careers, biographies, and personalities of four noted American regulators to argue that each became an "independent social force determining the structure of agency regulation." J. Seligman adopts a similar perspective on the history of the Securities and Exchange Commission in the United States (SEC), according considerable importance to the philosophies and policy preferences of the agency's leadership over the years.

Other explanations for regulatory behaviour emanate from variants of economic public choice theory, which propose that resources are allocated by regulators to those recipients who seek them most forcefully, usually "relatively small and well-organized groups that have a high per capita stake in the regulations," rather than poorly organized groups. For example, G.J. Stigler argues that the "central tasks of the theory of economic regulation are to explain who will receive the benefits or burdens of regulation, what form regulation will take, and the effects of regulation upon the allocation of resources." He received a Nobel Prize in economics in part for his development of "capture" theory, which predicted that a regulatory agency would tend to be captured by the interest groups with which it was most closely associated. A similar analysis was developed by G. Kolko in his study of early American railroad regulation. He argues that regulation was sought by those who ran the railroads to protect their own interests against those of consumers and workers. As a Marxist historian, Kolko would come to different conclusions about the appropriateness of this result. More recently, I. Ayres and J. Braithwaite have posited the idea of a "continuum" of capture, in order to model varying relationships between regulators and the regulated in different regulatory arenas. As a policy prescription, they argue for "tripartite" practice of regulation, to take place among regulators, the regulated, and PIGs (Public Interest Groups) in order to produce more "responsive" regulation.

The obvious point of convergence of these various explanatory models is a focus on the role of interests—of regulators, of the regulated and of the more diffuse public interest. The assumption is that knowing the configuration of interests will allow reliable prediction of the outcome to regulatory decision-making and therefore an assessment of the "success" or "failure" of an agency. Agency behaviour is thought to result from the rational assessment of the constraints or opportunities afforded by the desires of specific interests.

As an account of what happens in regulatory agencies, this approach seems deficient for a number of reasons. In the first place, "interest" tends to be treated in these analyses as an unproblematic concept and, empirically, as easily discoverable. With respect to so-called "private" interests, it tends to be assumed that autonomous social actors adopt interest positions that are coherent, specifiable in advance, and unchanging over the course of a particular debate. Little attention is typically paid to the formulation of interest positions in the first place. For example, E. Meidinger argues that "self-interest is not a given; it must be constructed and can be reconstructed. How self-interest will be played out institutionally, and moreover, what sway it will be given, are also choices." Indeed, the social locations of actors are often assumed to produce specific interest positions. In other words, the interest group is conflated with the objective desired. Second, a number of commentators have made the point that exponents of "private interest" theories of regulation tend to confuse regulatory effects with causation. Once it is discovered that a new regulatory practice benefits some identifiable constituents, a leap is then made to the assumption that the practice was put in place so as to benefit those constituents. This leap can be made with respect

to both inside and outside interests, that is, where the practice affords benefits to regulated entities (or other intermediaries) in the regulatory relationship or to the agency itself.

Third, the analytical distinction usually drawn between public interest and private interest theories of regulation is somewhat problematic. For one thing, one understanding of the public interest is that it consists precisely of the sum of individual private interests and so is indistinguishable from those prior interests. For another, the distinction is intellectually a product of the public/private divide at the core of liberal political theory, whereby the private sphere of action is separate from the public sphere and should be inviolate. This distinction may be increasingly empirically invalid. Thus, L. Hancher and M. Moran argue that the "capture" debate obscures perhaps the single most important feature of economic regulation under advanced capitalism: that the most important actors in the process are organizations, and organizations which, regardless of their formal status, have acquired important attributes of public status. Of the formally "private" organizations with public status, none is more important than the large firm. ... Economic regulation of markets under advanced capitalism can thus be portrayed as an activity shaped by the interdependence of powerful organizations who share major public characteristics. In the economic sphere no clear dividing line can be drawn between organizations of a private nature and those entitled to the exclusive exercise of public authority. The persistence of self-regulatory organizations in the practice of Ontario securities regulation bears witness to this point.

At the least, the focus on outcomes required by interest group theorizing obscures the question of *how* it is that actors may have their interests met by regulation. As one way of achieving greater understanding of the regulatory process and beginning to answer the question of how outcomes occur, Meidinger proposes a concentration on the notion of a "regulatory culture." Thus "a cultural perspective focuses on the understandings that are negotiated and enacted by actors in regulatory arenas. It tends to presume that those understandings are important in their own right and are not simply reducible to other factors, such as pregiven material interests or power." He argues that this focus on negotiated understandings and "shared ideas" as a vital component of regulatory culture "may support an intermediate analytical position which avoids the rigid overdetermination of structural models and the mushy underdetermination of individualistic models of social life."

QUESTION

As an example of the application of these various critical perspectives on securities law rules, consider one of the most basic rules of securities law, the prospectus requirement. This requires that issuers provide to prospective investors a detailed prospectus that includes information about the securities to be offered, the financial position of the issuer as reflected in its financial statements, the risks associated with investing in these securities, and aspects of the internal governance of the issuer. How would the existence of this rule be analyzed under the various perspectives described above?

III. SOURCES OF SECURITIES LAW

The legal regulation of securities markets and securities trading is accomplished by way of statute, regulations, rules, policy statements, and, of course, judicial decisions. Securities law in Canada is typically administered by an expert tribunal, such as the various provincial securities commissions, though self-regulatory organizations also play a key role in the delivery and implementation of regulation. We will see that significant power and autonomy is typically granted to regulators to interpret, elaborate on, and apply the statute, rules, and regulations. As discussed in chapters 2 and 11, the Supreme Court decisions in *Pezim*, *Asbestos*, and *Cartaway* are illustrative in this regard. A key issue is that the scope of securities law does not end with the statute; various kinds of delegated legislation are crucial to understanding the nature and extent of the law. Thus, sources of securities law could be described in terms of the texts that are used to find and apply the law, or in terms of the various institutions and organizations that apply it.

The authoritative texts of securities law comprise the following sources.

A. Provincial Securities Statutes

All of the provinces and territories have legislation governing the issuance of securities and the operation of securities markets. Although Ontario's *Securities Act* has been amended a number of times over the last few years, the basic structure of the underlying principles (to do with matters such as the disclosure of information to investors, the creation of the so-called exempt market, the prohibition on insider trading, and the regulation of takeovers) has remained unchanged since the last major overhaul of the statute in 1978. One more recent innovation, in 1994, has been the elaboration of specific objectives that securities regulators are required to achieve, along with a number of principles that elaborate on those objectives. See ss. 1.1 and 2.1 of the OSA. A number of provinces have followed the Ontario model very closely (especially Saskatchewan and Alberta in the west and Newfoundland and Labrador and Nova Scotia in the east). At the time of writing, British Columbia is planning to enact a new statute that will represent a significant departure from traditional ways of regulating securities markets. As we will discuss in more detail in chapter 1, in an increasingly global securities market, questions have been raised about the ongoing adequacy of provincially based regulation. Nonetheless, it is important to emphasize that a clear appreciation of the scope and content of securities law cannot be obtained without a thorough familiarity with the provisions of the statute.

B. Regulations and Rules

Provincial securities acts typically include the power to make *regulations* under their authority. In Ontario, for example, this authority is exercised by the lieutenant governor in council. However, this form of delegated legislation is of decreasing importance in some of the bigger provinces, which have provided a *rule-making* power to the regulator itself, subject to a "notice and comment" procedure and the approval of the provincial minister responsible for overseeing the activities of the regulator. The power to make rules, which has been very significant for the securities regulators who have it, was first